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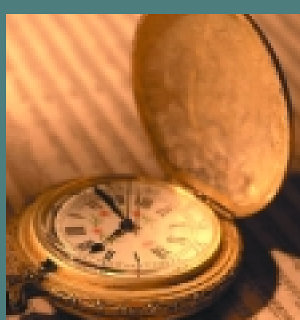
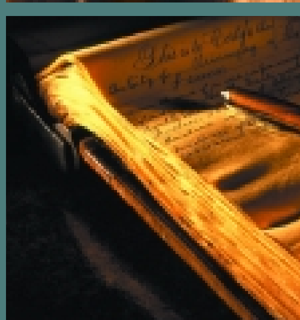
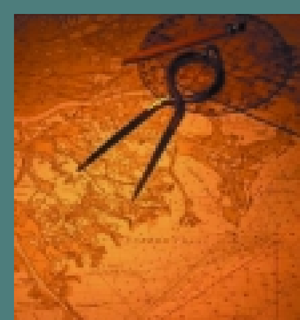
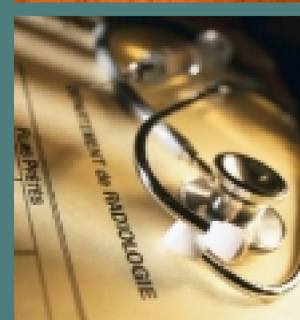
PRIVATE PLACEMENT LIFE INSURANCE:

New Insights for an Enduring Technique









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Private Placement Life Insurance: New Insights for an Enduring Technique

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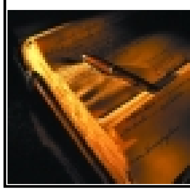
PRIVATE PLACEMENT LIFE INSURANCE has become an increasingly popular planning technique within the estate planning community. Unfortunately, a great deal of confusion has arisen as to its practical applications due to the lack of guidance for the tax practitioner.



Planning techniques are normally developed to solve one specific problem, while remaining neutral in respect to another area. Periodically, a technique is found that can address many aspects at one time, which makes that technique particularly useful in a variety of planning environments. Private placement life insurance (PPLI) is one of those tools that is truly a cross spectrum technique. Having elements of life insurance, investment, estate and income tax planning, PPLI can accomplish many goals at one time.

Unfortunately, implementation of the appropriately structured PPLI program takes the input from investment, insurance and tax professionals in order to work appropriately within a specific client fact pattern. Although many other techniques require planning professionals to have only limited knowledge of their counterpart's area of expertise, PPLI requires each participant to have much more of a broad based knowledge platform. This is especially true of tax advisors who will most likely spearhead the planning elements of PPLI, but may not be fully conversant in the various insurance rules that will apply. This "white paper" is designed to help bridge these gaps.

What is PPLI?

PPLI is a life insurance contract that has substantially reduced costs and much greater investment choices than in traditional retail contracts. Furthermore, PPLI products normally have minimum annual premiums of at least $1 million, and thus it is a tool for only wealthier individuals. For many people, PPLI is simply the product of choice for buying death benefit at the cheapest cost. For others, placing substantial sums of money into a vehicle whereby they can choose a manager who will customize the portfolio and let the assets grow income tax free. In these situations, the death benefit provided by the insurance is secondary to the tax benefits. Finally, for others it is utilizing PPLI as one component among many in a myriad of tax planning scenarios but doing so with a contract that is cheaper and more flexible than might otherwise be available.

PPLI is often cheaper since it does not carry the traditional 40-80% commission that retail products carry. In most situations, commissions and/or planning fees related to PPLI are individually negotiated with the client. These fees are much more likely to be asset-based fees (in line with traditional money management fees), rather than large premium-based fees. Unlike the traditional distribution of insurance products through insurance agents, most PPLI products are utilized as a planning tool by tax and investment professionals, and thus in many situations the middleman/agent has been removed. This is especially true in the institutional use of PPLI.

PPLI is more flexible from an investment side in that the insurance companies can hire individual managers to invest in stock portfolios, hedge funds, private equity, and REITs. This is in contrast to the limited number of traditional mutual funds offered in retail products. Just as individuals with $10 million portfolios rarely invest a majority of their assets in mutual funds with the associated fees and restrictions, instead being more likely to have a customized portfolio with non-traditional investments, so too would you expect this same preference with an insurance policy with a $10 million cash value. It is only through PPLI that these types of investments can be incorporated into an insurance product.

It is important to note that private placement annuity contracts, as opposed to life insurance, do exist. Since most annuities are used for pure income tax deferral, the corresponding ordinary income tax treatment associated with annuities (to be discussed later) makes their use somewhat limited when contemplating multi-million dollar premiums. The potential unwinding of the entire account at ordinary income tax rates and the restrictive ownership issues under the Internal Revenue Code (Code) Section 72(u) present significant hurdles to be addressed.

Nonetheless, there will be situations where annuity contracts might be used, such as in deferred compensation, and other transactions where the income tax treatment will not necessarily change. The general tax deferred nature of life insurance and annuities and the special rules regarding variable contracts are the same. However, many planners feel there is more certainty in the laws and regulations addressing the treatment of life insurance contracts.

In general, individuals utilize PPLI because of the increased investment flexibility, the dramatic decrease in overall costs, and the ability to customize many elements of the contract over time. Although the due diligence on the actual tax aspects of PPLI is quite straight forward, to be discussed shortly, there are clearly some psychological elements of PPLI that often create the proverbial paralysis by analysis. Sometimes the most common question is "If this is so great, how come I haven't heard of it before?" This is a valid and poignant question that deserves a straightforward answer.

History

Although the permutations have changed somewhat over time, the core structure of PPLI has remained relatively unchanged for some twenty years. A quick historical overview is necessary so that practitioners can understand that PPLI is not a new, and thus untested, cutting edge planning technique. It is only by understanding the history of a technique that one can determine its applicability for today's planning scenarios.

PPLI really began as a way of customizing specific types of insurance products as part of corporate benefit planning for senior executives. Although the rank and file employees may have been happy with the benefits of more typical insurance offerings, senior executives often desired greater investment options, lower fees, and greater overall customization. This, in conjunction with the growing use of variable contracts, led to the birth of individualized PPLI products.

The Internal Revenue Service (Service) initially ruled on these types of customized variable products in a series of

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Revenue Rulings from 1977-1982.[1] With inflationary pressures at that time many states increased their state premium taxes[2] on life insurance and annuity contracts. As the regulatory costs rose, coupled with changes in 1984 regarding taxation of insurance and annuity contracts, and an overall reduction in tax rates in 1986, the need for PPLI just faded away. Domestically there was little activity in the personal PPLI market other than Corporate Owned Life Insurance (COLI) and Bank Owned Life Insurance (BOLI) transactions during the late 1980s.

In the early 1990s, PPLI products for wealthy individuals surfaced again out of the Channel Islands. Soon after that, Cayman Island and Bermuda based products started to surface. As the hedge fund industry started to pick up steam during this period, many of the products were being specifically developed for these investments.

In the mid 1990s, many of the major U.S. and European carriers entered the international PPLI market, which brought this type of planning back into the mainstream. As of today, there are a few dozen international carriers (mostly small private carriers) who allege to have U.S. qualified contracts. Although many of the carriers have excellent credentials and administrative capabilities, there are certain carriers who have questionable programs, as is so often true with certain aspects of "offshore" business.[3] However, due to the volume of quality carriers both internationally and domestically, there is little reason why an informed client would choose these questionable carriers.

In the last few years of the last decade, many of the carriers started to offer domestic products. As of this writing, there are about twenty U.S. carriers who either have, or will shortly have, U.S. registered products.

In many ways, the business cycle of PPLI has come full circle, although it has taken twenty years. Perhaps the biggest problem with such a long business cycle is the lack of knowledge retained by many of the institutions and advisors who represent wealthy individuals. There has been for all practical purposes a generation gap of advisors who may have worked on PPLI years ago, but are now retired. While at the same time many of today's senior tax advisors may have only been junior associates at that time, or were involved in a different practice area. For many reasons, there is a substantial information void among today's tax advisors as to the true uses and applicability of PPLI.

Technical Overview

PPLI in its purest sense is quite easy to understand, although applying it in a planning situation is a bit more complicated. It is critical to view PPLI as a planning tool, rather than as a product to be sold. PPLI is a variable universal life contract that has stripped out all of the retail pricing and markups, while at the same time allowing policy owners to choose and/or suggest the use of specific investment managers, subject to normal due diligence and investor control issues (to be discussed later). It is important to note that some PPLI programs, most often built for insurance agents, are heavily laden with commissions, which make them as inapplicable as traditional retail contracts.

There are three primary uses for PPLI in today's planning environment. First, individuals who need a substantial amount of death benefit are using PPLI to purchase insurance at a greatly reduced price due to its institutional pricing format. Second, individuals who need this coverage and/or are looking for a long-term repository of their funds are attracted to the favorable tax treatment of life insurance in reducing the overall income tax on these investments. Finally, advanced planners are utilizing PPLI as an integrated planning tool for employee benefit, estate tax, and cross-border planning. With those primary planning objectives in mind, it is appropriate to set out some preliminary issues for the reader who has not had extensive experience in the tax aspects of life insurance and annuity contracts.

The term "life insurance contract" refers to any contract which is a life insurance contract under applicable law (without the benefit of what the term "applicable law" means), **but only** if the contract meets one of two separate requirements.[4] The first alternative is meeting the so-called "cash value accumulation test".[5] The second alternative is meeting a two pronged test: the so-called "guideline premium requirements"[6] and the "cash value corridor" test.[7]

Although PPLI products can be structured under either test, it is most common to see the Guideline Premium / Cash Value Corridor test used. This test usually dictates that a certain flat face amount[8] on the policy will dominate for the earlier years until the cash value of the account grows enough to have the cash value corridor test "kick-in". For the life expectancy of most insureds, it is likely that the corridor test will be the dominating test for most of the policy's term. An example of this is addressed in the underwriting section to follow.

PPLI contracts are considered universal variable life contracts. The term "variable contract" is defined in Code § 817.[9] The term includes annuity contracts and life insurance contracts whose benefits are tied to the investment performance of accounts which are segregated from the general accounts of the issuing company. In the case of an annuity, the annuity amounts paid in or out are tied to the investment performance and market value of the account as opposed to a fixed or guaranteed rate. Similarly, for a variable life insurance product, the amount of the cash value and death benefit fluctuates or varies with the performance of the underlying assets.

Life insurance death benefits. As a general rule, life insurance death benefits are not includible as gross income to beneficiaries.[10] There are exceptions, the most notable being transfers for value[11] and an interest element if payment of the death benefit is payable in installments or otherwise delayed.[12]

Estate taxes and insurance. If the insured retains **any** incidents of ownership in the policy, the insurance proceeds will be included in the insured's estate for estate tax purposes.[13] Furthermore, transfers of the policy accompanied by the transfer or relinquishment of all incidents of ownership will not remove the proceeds from the estate of the decedent if such a transfer occurs within three years of the death of the decedent.[14] Suffice it to say that with proper planning, life insurance proceeds can be excluded from the estate. It should always be remembered that PPLI is a standard life insurance chassis, and all the traditional gift and estate tax rules apply.

Inside buildup. The buildup within both life insurance and annuity policies is generally free from current inclusion in gross income.[15] In the past this led to the use of insurance policies solely for the purposes of investment planning. To curb those abuses, Congress redefined "life insurance policy" by enacting Code § 7702. Furthermore, Congress wanted to limit access to the policy values during the term of the policy, resulting in the enactment of the modified endowment contract (MEC) rules (to be discussed shortly).[16]

Distributions. If distributions are made out of the policy, such distributions will be specifically included in gross income. Annuitized distributions can be considered partially a return of premium and earnings. A critical issue in determining inclusion within gross income is found in Code § 72, which distinguishes between "amounts received as an annuity" and "amounts not received as an annuity". "Amounts received as an annuity" are amounts which are payable at regular intervals over a period of more than one full year, provided that the total amounts payable or the period for which they are paid is determinable.

CHART 1

In the case of an insured with an attained age as of the beginning of the contract year of:		The death benefit shall be equal to the cash value multiplied by the following percentages:	
More than:	But not more than:	From:	To:
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

Note: The above Chart shows the bands during certain periods. Actual percentages apply to each individual age at a ratable portion.

Any other amounts not considered as "amounts received as an annuity" will be considered to be "amounts not received as an annuity". This applies to both life and annuity contracts, regardless of the term "annuity".

"Amounts received as an annuity" are treated **partially as a return of premium** and **partially a return of the appreciation of the premium.** The return of premium is tax free, the return on principal is subject to income tax. Employee annuities under Code § 72(d) are treated somewhat differently and will not be further discussed in this article.

"Amounts not received as an annuity" are generally includible in gross income to the extent the amounts exceed the premiums or other consideration paid. This LIFO (last-in-first-out) treatment limits the tax deferral treatment of insurance contracts by always causing a distribution to be considered fully includible in gross income unless it is a return of premium.

Income taxation changes under Code § 72 depending on whether the payments are received by the annuitant or a beneficiary.[17] Proper distribution planning is critical in any insurance or annuity transaction.

Modified Endowment Contracts. The MEC rules of Code § 7702 were enacted under the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) and were primarily targeted at single premium life insurance policies. In order to discourage the purchase of these products for tax planning purposes, Code § 7702A makes an exception to the general rule applicable to non-annuity amounts, i.e., non-periodical distributions, from life insurance contracts.

For purposes of Code § 72, the term "modified endowment contract" means a contract (entered into on or after June 21, 1988) otherwise considered a "life insurance contract" (i.e. meeting the requirements of Code § 7702 as outlined below) which fails to meet the so-called *"7-pay test"*[18] or which is received in exchange for such a contract. The alternative is referred to as a Non-Modified Endowment Contract (Non-MEC).

> Each of the segregated accounts underlying a variable contract must satisfy strict diversification requirements. The diversification requirements were provided to discourage the use of tax deferred variable life insurance or annuity products strictly as investment vehicles.

Under a MEC, loans are treated as distributions (non-annuity amounts). If a loan is made under a MEC, or if dividends are used to pay back a loan or interest on a loan, those amounts will be considered a taxable distribution. An additional 10% penalty tax on distributions made prior to the date the taxpayer reaches the age of 59 fi is also imposed on a MEC policy distribution.[19] This is to effectively prohibit taxpayers from using a MEC as an alternative retirement planning vehicle. There are certain exceptions, very similar to the ERISA rules, for early withdrawals from the policy. Loans from Non-MECs are not taxable.

One needs to be cautious when dealing with reducing the face amount of a Non-MEC during the early years so that it will not be converted to a MEC. This rule, as well as the general scheme of Code § 7702A, is not unique to PPLI contracts, but it is absolutely critical that the planner have a detailed working knowledge of these rules before implementing any insurance based plan.[20]

Special Considerations For Variable Contracts

Diversification requirements of variable contracts. Each of the segregated accounts underlying a variable contract must satisfy strict diversification requirements. The diversification requirements were provided to discourage the use of tax deferred variable life insurance or annuity products strictly as investment vehicles.[21] These rules apply to retail contracts alike, but since all retail contracts are structured in a mutual fund setting, diversification does not need to be monitored as much as in PPLI. In terms of the details of diversification, they can be found in Treas. Reg. § 1.817-5. The general requirements are that the investments of a segregated asset account shall be considered adequately diversified for purposes of Code § 817(h) only if—

(a) No more than 55% of the value of the total assets of the account is represented by any one investment;

(b) No more than 70% of the value of the total assets of the account is represented by any two investments;

(c) No more than 80% of the value of the total assets of the account is represented by any three investments; and

(d) No more than 90% of the value of the total assets of the account is represented by any four investments.

In addition, there are special rules for "safe harbor" investments in United States obligations, and so called "look through" rules to assets which are under certain umbrellas such as regulated investment companies or trusts.[22] In most situations the diversification test must be met on the last day of each quarter starting after an initial 12 month diversification free period.[23] Finally, for portfolios that have a large percentage of real estate assets, there is a more complex 60 month diversification requirement.[24]

Consequences of a failure to diversify. The consequences of a failure to satisfy these requirements are severe indeed.[25] Failure to satisfy the requirements results in the contract not being treated as an annuity, endowment, or life insurance contract for any calendar quarter period for which the investments of any such account are not adequately diversified. What is worse, the disqualification continues for any subsequent period, even if the investments are adequately diversified for such subsequent period. The result is that any income on the contract must be included by the policyholder as ordinary income received or accrued by the policyholder during such year. [26]

Investment management and control. The IRS has made it clear through letter rulings and the like that the policyholder cannot select, manage or control the investments of the segregated account. This has come to be called the Investor Control Doctrine. It is by far the most hotly debated issue in the PPLI industry due to some of the vagueness of the direction the Service has provided.[27]

Revenue Ruling 82-54 provides a summary and discussion of the applicable letter rulings on this matter.[28] To summarize, the investor may designate an investment strategy or even a particular segregated account offered by the insurance company. However, the policyholder cannot and should not be possessed of sufficient "incidents of ownership" of the segregated assets to be deemed the owner of the assets for income tax purposes. If this occurs, the tax advantages of the policy would be lost. The letter rulings advise that the policyholder may choose among general investment strategies, either at the time of purchase or subsequent thereto, without being deemed the owner. The policyholder should not be permitted to vote shares or otherwise control the segregated assets. The segregated assets may be managed by an independent investment advisor. However, such advisor must be retained by the insurance company, not the policyholder. The segregated assets may not be composed of registered investment funds generally available to the public; access to funds must be restricted to annuity or insurance contracts.

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Until recently, there was still some question as to the Service's position when it came to unregistered private partnerships like hedge funds. On November 1, 2002 the Service released Private Letter Ruling 200244001.[29] This ruling has already started a substantial debate regarding the Service's position on this matter for two reasons. First, many current PPLI offerings directly invest in non-registered investment partnerships. Second, the Service has made a conclusion not adequately supported by the current Regulations, and some might even argue that the ruling is directly contrary to the Regulations.

As of this writing, there has been no other published guidance indicating whether the exclusivity rule governs these partnerships, although the regulations seem to clearly indicate that it does not. For this purpose the exclusivity rule means that such non-registered partnerships cannot have both insurance related investors and non-insurance related investors, or there is a breach of the investor control doctrine. Furthermore, although it would seem moot at this point, there is no look-through for diversification purposes.

The debate will center around the inconsistency of the Regulations, Conference Committee Reports, Revenue Rulings, and finally the actual Private Letter Ruling. Specifically, the Service is taking an extremely strict reading of the Committee Reports, while effectively ignoring the actual wording of the Regulations themselves. Without any explanation, they find that the Regulations and the Revenue Rulings are consistent with their opinion.

Clearly, for new cases, regardless of one's opinion of the Ruling, a restructuring of planning must be considered with these types of investments. The easiest way to resolve this is to simply clone the investment into a partnership that will only accept insurance-based investors. This will no doubt cause some additional legal fees, but this should be a minimal cost if several investors plan on utilizing the new investment option within the policy. The second key way would be to have an allocation or fund-of-fund structure designed within the policy that then invests in these partnerships. This follows the guidance set out in PLR 9851044[30] in which the Service stated that a fund that satisfies the investor control requirements will not fail merely because the fund invests in a publicly available fund.

For most practitioners in this area, the concern is not so much the end result of the ruling, but rather the methodology by which the Service reached that ruling. The general consensus at this point is that the Service, in this situation, wanted to take a certain position regardless of the actual issues outlined in the Regulations. Perhaps this is some type of foreshadowing of a new Notice or Revenue Ruling addressing this matter.

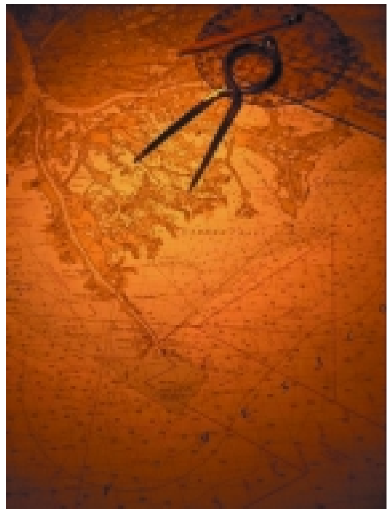
Offshore vs. Onshore Carriers

As was previously mentioned, the offshore carriers really dominated the market during the 1990's. However, the recent trend has been decidedly domestic, especially for financial services companies worried about foreign issued products from a regulatory standpoint. Nonetheless, in the past there were, and continue to be to some extent, three primary reasons to implement an offshore policy over a domestic one beyond the fact that very few domestic alternatives existed in the past.

Offshore carriers take the position that foreign issued contracts are not subject to state premium taxes. This is based upon the solicitation, application, and in some instances the underwriting all being completed internationally.

In the last few years, two states, Alaska and South Dakota,[31] have implemented reduced state premium taxes that have dramatically cut this cost to a policyholder and have reduced the impetus toward offshore insurers. In both of these states, the premium tax on a $10 million premium would result in a savings of at least a hundred thousand dollars over most other states. The tax is a graduated tax, but on a $10 million premium it would be approximately ten basis points (one tenth of a percent). However, in order to take advantage of this premium tax, one must have a contractual nexus to these states. This is often done by having the policy owner be either a trust, partnership or corporation domiciled in such states. In addition, the application and perhaps even the solicitation must be done in the states as well. The burden of determining which state will receive the state premium tax lies with the insurance company, and thus the determination of how to allocate premium taxes differs from company to company.

The next benefit foreign issued contracts have over their domestic counterparts is that the securities regulatory environment is slightly more liberal internationally. Although this should be a concern for most clients, wealthy individuals usually have proper representation to avoid the ever changing world of securities scams in the "offshore" world. The major benefit is that foreign issued contracts can invest in foreign registered securities that cannot be sold to U.S. persons. Since most U.S. individuals do not actively seek these types of funds, and due to the fact that many of these managers do have U.S. registered products, this benefit is much more illusory, not likely creating any substantial benefits other than for only the most sophisticated investors.



The final benefit is the fact that foreign issued contracts are not "burdened" by many of the state consumer laws on policy contractual issues. The consumer laws of all insurance policies in the U.S. generally follow the model rules of the National Association of Insurance Commissioners (NAIC). Like most consumer laws, the rules were established to protect the less sophisticated consumer, and these laws work well for the traditional policies issued in every day life. However, for the wealthy client who wishes to place several millions of dollars into a policy, many of those rules can actually limit the policy design options. These policy design options center around the contractual definitions themselves of a life insurance contract.

Although one must still follow the general qualification rules of Code § 7702 in order to maintain the policy as qualified as life insurance for federal income tax purposes, many of the consumer laws have an indirect effect on the tax laws. As an example, items like net cash surrender values and how they are calculated are often dictated by the policy contract, and vary from company to company. Items like surrender fees, crediting rates, commissions, mortality rates, etc. all have an effect on this value. None of these items are dictated by the Service (other than the general mortality rates), but these consumer law items can have a profound effect on the net cash surrender value of the contract that is used for gift and income tax purposes.

In many situations, foreign policies are drafted to be either more or less restrictive, so that the policy will be more efficient on a design basis. This can be done internationally without the undue effect of some of the consumer law limitations. This opens a host of planning options internationally for everything from split-dollar to employee benefit planning, not to mention domestic and cross border estate planning.

Regardless of the perceived and/or real benefits of an internationally issued contract, many clients will still feel uncomfortable with the foreign "taint" of conducting any element of international planning. For those individuals who are normal investors, are willing to pay a slightly higher implementation fee (state premium tax) and are not looking for advanced policy design options, the domestic contracts will more than adequately meet their requirements. Due to the regulatory issues of implementing and selling a foreign issued life insurance contract, it is not surprising that financial institutions heavily favor the domestic versions simply from a regulatory view. Although these institutions will still utilize foreign based contracts, it is done more on an ad hoc basis rather than as a matter of normal planning for U.S. taxpayers.

A Detailed View Of A PPLI Contract

PPLI contracts are not dissimilar from their retail counterparts. As previously mentioned, most variable PPLI contracts look much like any other variable universal life contract, but with a few notable exceptions. For the tax advisor who has dealt with life insurance in the past, they likely had little or no ability to negotiate the terms of the contract, and thus these retail policies were literally on an as-is-where-is basis. Retail contracts are often filed with fairly restrictive terms, and changing these terms can be very burdensome in some states. Such changes are not as burdensome with the PPLI formats.

Pricing

Perhaps the most complex issue for today's advisors and non-insurance based institutions to resolve are the somewhat complex pricing models that vary from carrier to carrier. More problematic is that most advisors (including many insurance professionals) don't really understand the pricing models of the carriers. This is simply due to the fact that advisors have been accustomed to the take-it-as-it-is retail mentality of insurance. It is safe to say that most advisors have not had to conduct an in-depth analysis of the inherent pricing models of an insurance policy. In the past, the driving force was which company could deliver the lowest amount of premium for the right amount of death benefit. With PPLI, since the death benefit is not the only motivation, but rather the long-term buildup of the cash value, small inherent cost differences have a substantial effect on the benefit of one carrier over another.

What follows is a brief overview of the basic costs of PPLI and how an advisor can intelligently compare one product to another for the benefit of the client. Focusing on one cost alone is a dramatic mistake, in that carriers can move prices around quite easily, and it is not unusual for the product that actually looks cheap to be one of the more expensive options in the market. Costs fall into three major categories: regulatory, annual insurance charges, and investment related charges.

Although sales and distribution fees are an additional cost, one must be able to look at the core policy in order to compare contracts on an equal footing. Since sales commissions are often individually negotiated, the informed advisor will first know which product is best suited for the client, and then individually negotiate the sales fee. This can often be difficult in that the vast majority of insurance products today have built in sales commissions that are not explicitly disclosed to the buying public. Although one normally does not see this in PPLI, there are certain carriers and products that "bury" the sales commission within the product.

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Regulatory Fees

The regulatory fees differ depending on whether the policy is foreign or domestically issued. If a policy is issued by a foreign company which has not made a Code § 953(d)[32] election, then the policy owner will incur a 1% federal excise tax under Code § 4371.[33] It is assumed that a foreign issued contract will not incur state premium taxes, and this is the only regulatory fee normally associated with these policies. Please note, this assumes the policy is issued in a low tax jurisdiction that does not have its own regulatory costs. For domestic issued contracts there is the appropriate state premium tax for the policy. Currently, the average state premium tax is around 2-2.5% of the premium as it is paid into the policy.

A U.S. issued policy or a foreign issued policy by a company that has made a Code § 953(d) election will not incur the excise tax, but the company will charge a Deferred Acquisition Cost (DAC) charge.[34] This is sometimes erroneously called the DAC tax. In fact it is not even a regulatory fee, but it is easiest to discuss it in this section. The DAC varies from company to company, and usually is in the range of 50-150 basis points.

Together, on a domestic basis, a policy owner should expect to see a total deduction from their premium of anywhere from 1% to 4%, depending on the state and carrier used. The excise tax, state premium taxes, and the DAC are incurred only at the time premiums are paid into a policy. They are not annual fees.

Many of the larger carriers can amortize these costs within the policy. That is, instead of taking 3% of the premium off the top, the carrier can simply pay these fees, and then charge the policy owner an increased annual fee that amortizes these costs over a certain period of time. One should amortize these costs if they believe that the growth on their investment account will be greater than the amortization rate the insurance company uses. Since an upfront fee is now being spread over time, most carriers who accommodate this will require a surrender fee equal to the present value of the unpaid amortized costs.

M&E And COI

The annual insurance costs fall into two major categories: Mortality & Expenses (M&E), and the Cost of Insurance (COI). These are perhaps the most important, but also the most confusing costs to understand. The primary reason for this is that although separately charged and calculated, the carriers view the totality of both charges to calculate their profitability. The M&E is in the total control of the carrier since it is a fee that they keep. The COI floor is what reinsurance companies will charge on a purely wholesale basis for reinsuring part or all of the true insurance coverage of the policy.

It is not unusual to see one carrier with a high M&E have a low COI rate, while another carrier may have just the opposite. In the end, they could actually be comparably priced. However, since some policies have an emphasis on death benefit, while others might emphasize cash build up, the appropriate carrier must be used that properly matches a client's primary needs. Choosing the wrong carrier can cost a policy owner literally millions of dollars.

The M&E in PPLI is really the fee a carrier charges for issuing and administering the policy. It is usually an asset based fee that is calculated based upon the cash value of the contract, rather than the death benefit. It is unrelated to the amount of insurance needed, the underwriting status of the insured, or any other variable other than the cash value. It is this fee that generates most of the revenue for the carriers, and thus the fee structures vary dramatically from one carrier to another, and in many situations vary dramatically within different offerings of the same carriers, as will be explained later.

For the non-insurance professional, and really for most practitioners other than the actuaries, the concept and pricing of a company's COIs can be mind boggling. The primary reason for this is that few practitioners ever even look at COI tables, and more importantly, even fewer conduct a side-by-side comparison. However, many "games" can be played with COIs for marketing purposes.

For instance, one carrier was asked by its distribution source to reduce the COI charges in the first year of the illustration to below its true COI costs. Why? Because many practitioners and clients only look at the first year COI charges to compare one company over another. If one illustration shows the first year hard cost of mortality to be $10,000 and all the other carriers are charging around $25,000 for that year, it is a normal response to think that the first carrier must have overall cheaper expenses. However, carriers are not doing this for free, and will makeup for this in subsequent years by increasing their COIs in less visible years, and often times quite dramatically.

Another carrier advertised a great reduction in their costs hoping to spur business. They dropped their M&E a substantial amount, but an almost dollar for dollar increase was made to the COI. In the long run, the end price to the client was almost exactly the same. It was simply a sales and marketing issue, but with little savings to the client. Unfortunately, many advisors thought that there were dramatic savings, but never bothered to look further.

It is not unusual to see a carrier with several products with completely different COIs. Sometimes state premium taxes, DAC, and even commissions will be amortized into the COI. This in many situations can double and even triple the values. If a company builds in surrender fees coupled with escalating increases in the COIs, this markup will be almost imperceptible to the client and their adviser.

This process of moving fees and costs into the COI is neither unethical nor highly deceptive, it is just the way that most insurance products have been built over the years. It is simply the fact that state consumer laws do not require a detailed breakdown of these fees to the client on a comparative basis. Although clients are concerned about the apparent "hiding" of fees, the more important question is how to compare different companies with different levels of disclosure. It is only through an independent analysis of looking behind the curtain that clients and their practitioners will become enlightened on such issues.

Ask yourself, when was the last time you looked at and compared the COI rates for different companies, not just the hard costs, of a life insurance contract in years 15-20? Is the contract a twenty-year level select, or is some other design standard being used? The point is, actuarial designs can be as confusing and sometimes even more manipulated than advanced tax planning. Insurance agents for years have been able to go back to their carriers and request different premium quotes for the same amount of coverage. The motivating factor there was to reduce the premiums. However, the hard and honest facts are that carriers know exactly what their costs are and have an ability to move them around by front loading, back loading, changing surrender fees, using different amortization schedules, and moving fees between M&Es, COIs, investment fees, custodial fees, etc. It is up to the practitioner to understand this so that the client is making a truly informed decision.

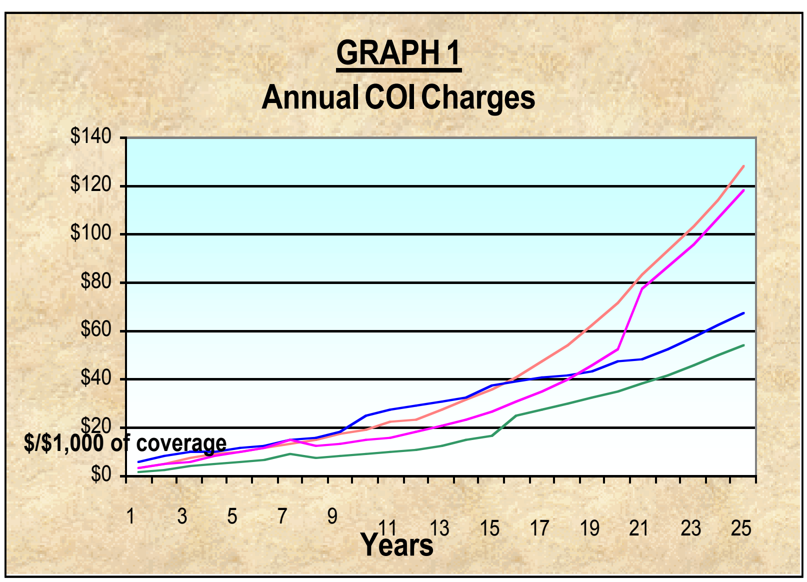

CHART 2

Policy Year	Cash Value "CV"	Face Amount "Face"	Net Amount at Risk "NAR"	NAR as a % of CV
1	$1,000,000	$3,200,000	$2,200,000	220%
10	$2,200,000	$3,200,000	$1,000,000	45%
20	$5,200,000	$6,000,000	$ 800,000	15%
30	$12,500,000	$13,100,000	$ 600,000	5%
40	$29,500,000	$31,000,000	$1,500,000	5%

As an example, Graph 1 shows a comparison of four different PPLI policies and their COI charges on a particular case. It is important to note the huge variations in pricing, and the changes that take place over time. Some carriers are cheaper in the earlier years, but by the tenth year are almost three times the cost of their competitors. Some carriers' charges increase at a somewhat proportionate rate tracking the 1980 CSO table rates, others have substantial increases or decreases at certain anniversary dates of the policy. The definitive point here is that practitioners must look at all aspects of charges, not simply the static early year numbers. This graph shows that the most expensive carrier on a Standard rating is equivalent to the cheapest carriers Table 3 or even a Table 4 rating. Does this mean that you never go with the higher mortality costs? That question can only be answered by determining why PPLI is being used in the first place.

The most important element of pricing is to look at the totality of pricing comparison in line with the actual needs of the client. Clients seeking a maximum death benefit amount for pure insurance purposes would be ill served to go to a carrier with low M&Es but high COIs. The same is true for clients who may receive table ratings due to health problems. In the same light, clients who want to maximize the internal cash value will best be served by a contract with lower M&Es. The reason here is that as the cash value grows the amount of insurance needed as a percentage of cash value drops, and thus makes the COI charges less draining on the overall account. It is important to test a certain policy at different growth rates and underwriting classifications to establish the range of applicability to the facts at hand.

Reinsurance And Underwriting

It is important for tax practitioners and the other non-insurance professionals to understand that PPLI is a life insurance product and thus has most of the typical life insurance underwriting and qualification tests common to other life insurance products. However, due to the specific design issues of PPLI, there are some notable differences. Perhaps the most striking difference arises from the actual amount of pure insurance that the insurance company and ultimately the reinsurers are liable for over time.

As an example, for a MEC contract on a 50 year old male, the guideline premium test requires that the contract have an initial face amount of approximately $3.2 million for a single premium of $1 million. In the first year, the Net Amount at Risk (the difference between the face amount ($3.2 million) and the cash value ($1 million)) is $2.2 million. This is an initial ratio of 220% of the original premium. However, as the cash value of the contract grows, and the corridor requirements of Code § 7702 go down, the Net Amount at Risk drops rather significantly. For instance, assuming a 10% growth rate on the internal assets, Chart 2 illustrates the changing relationship between cash value, the face amount, and the net amount at risk.

This chart illustrates that the actual amount of insurance coverage (net amount at risk) drops until age 75, rises again slowly until it peaks at age 90. This is all due to the corridor test of Code § 7702. Compared to a normal retail policy, the reinsurers often take a slightly lower risk with PPLI since it is likely that their risk will actually decrease over time. For PPLI policies with substantial net amounts at risk above the corridor requirements, one would expect the normal underwriting standards to apply.

The process of underwriting, including all of the appropriate medical tests is still a critical element of PPLI. However, it is important to note that since the use of PPLI goes beyond straight insurance needs, it is not critical to insure the traditional insured who happens to be the oldest and usually wealthiest family member. It is not unusual to see life insurance contracts in Generation Skipping Trusts (GST) where the insured is the twenty-three year old grandchild. This was not done for estate liquidity purposes when the grandmother and grandfather die, but more to simply shelter the growth of the assets within a policy for a longer period of time, at effectively cheaper mortality costs.

There are, of course, as many different reasons to choose one insured over another as there are families. It is simply another element of the planning design parameters of PPLI.

Planning Options And Examples

Traditional Insurance Needs. Although PPLI is quite flexible and serves various needs, one must remember that it is still, at its core, a life insurance contract. Although many wealthy individuals have an aversion to life insurance and the sales process that often accompanies it, there is no doubt that life insurance needs exist and must be filled. In many ways, there is no better way to fulfill the order for a life insurance need than by using PPLI. Due to the reduced costs, and the fact that the policy-owner can have greater input regarding the investment options, PPLI is well suited to serve traditional insurance planning needs, but with greater efficiency. In addition, with the reduced or non-existing commissions, the ability to separately negotiate costs can greatly affect the bottom-line pricing of a particular amount of insurance. Furthermore, there have even been instances in which a carrier has negotiated not only the M&E, but also the COIs.

Large life insurance policies are often used for estate planning, buy-sell, and other corporate purposes. In situations where large life policies are needed (or in some situations where large private placement annuities are needed) PPLI can be particularly cost efficient.

Investment Planning. Clearly, many individuals are utilizing PPLI not only as an insurance planning tool, but also as a tool to maximize the growth of the internal cash value for investment and accumulation purposes. This has been especially true where the underlying investments are hedge funds where most, if not all of the returns are subject to ordinary income tax rates. Due to Private Letter Ruling 200244001, as previously discussed, there will no

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doubt be a chilling effect on some aspects of PPLI planning in the hedge fund community. The requirement that cloning of hedge funds might be required within the PPLI market will no doubt keep certain fund managers away who do not wish to spend the time or expense on cloning a fund.

It is important to note that the beneficial income tax planning elements of PPLI still remain the same. The use of individual managers in a non-fund setting remains a viable option, and more importantly is most likely where most individuals will utilize PPLI. The mathematics of the tax benefits of PPLI are dramatic, and are the driving force for the use of PPLI as an integrated solution for long term investment management issues.

A quick example will illustrate the benefits. Assume that a person interested in investing in the equities market has a long term growth rate projection of 11% after management fees. Clearly, few have seen that type of growth, if any, in the last few years, but historically that has been the long-term projected growth rate of the S&P 500. Many promoters of PPLI will assume that the growth is fully taxable each year and will apply the maximum ordinary income tax rates to show the savings of PPLI. Unfortunately, this is an incorrect assumption.

Unless one is talking about hedge funds, bond funds, or a few other types of management styles, it is unusual for a traditional equities portfolio to have a 100% yearly taxable recognition of the gains. It is more likely that a 20-40% annual recognition of the gains is experienced. In addition, it is unlikely that all of the gains are taxed at short term or ordinary rates. In summary, a more traditional equities portfolio may have 30% of the gain each year recognized, and the blended tax rate (short and long term capital gains) may be 30% as well. Clearly, each manager has its own tax efficiencies, and these numbers vary dramatically, not only from manager to manager, but also for each manager on an annual basis.

For conservative purposes, the following will be assumed: a $10 million single investment growing at an 11% pre-tax rate, and with 30% of the gains each year taxed at a blended tax rate of 30%. Assuming a constant set of assumptions, the taxable account under these facts would grow to $112

million in thirty years. There would still be a small amount of untaxed built-in gain at that point, but recognizing this amount would still leave $105 million on a fully after-tax basis.

This should be compared to the same investment in a PPLI program. Further, assume basic costs of a policy (Mortality & Expenses and Costs of Insurance) which might average 75 basis points per year, and assume a 2% state premium tax and a 1% Deferred Acquisition Cost charge in the first year. In thirty years, the cash value of the contract will be $181 million. The actual death benefit would be some multiple of this number based upon the age of the individual. For instance, a policy with a cash value of $181 million on an 80 year old would require a death benefit equal to 105% of the cash value ($190 million) under the guideline premium/ cash corridor test.

The account has increased dramatically during this period simply because of the compounding tax free environment of PPLI. No more money was made or lost since the same manager was used. The same amount of money was made, the only difference is how much was kept and reinvested. This tax deferred analysis is exactly the same used to illustrate the benefits of retirement plans. However, the death benefit of a life insurance contract is tax free without any recognition of the deferral.

If the example was on hedge funds, private equity funds, or some other investment that might have a larger growth rate, or a higher blended tax rate, the savings would be even more substantial. Since the policy costs are fixed, the greater the earnings the greater the proportionate savings as measured against the cost of the policy. Accompanying the costs is a defined amount of life insurance that eventually will provide a benefit to the beneficiaries.

Estate Planning. Life insurance planning is intractably linked with overall estate planning, and it is difficult to separate the two. This is especially true with the nature of the larger PPLI policies. Second-to-die policies exist in the PPLI world and can be used to greatly reduce the overall costs of traditional second-to-die policies. Furthermore, life insurance policies themselves can be used as an estate planning tool. Some retail contracts have been designed to minimize the overall value of the policies (the net cash surrender value), as well as utilizing large expenses in the earlier years. Although core PPLI contracts provide neither of these benefits, it is often times easier to modify a PPLI contract than a normal registered retail product.

PPLI is often used as an income tax tool to complement the general "income tax neutral" aspects of estate planning. For example, placing a substantial amount of assets into a Generation Skipping Trust obviously results in dramatic savings in transfer taxes over a long period of time. However, since the GST is its' own tax paying entity at a compressed income tax rate, there is a great deal of income tax inefficiency. This arises in letting investments simply sit in the trust, while reinvesting in a taxable account for decades to come. Simply having the trust place some or all of the assets into a policy with the beneficiary being the trust itself will allow the trustee to have the assets in the trust compound for the benefit of the trust beneficiaries.

Even though the use of family limited partnerships coupled with the sale of partnership interests to a defective trust has become quite popular in estate planning, this combination still is income tax neutral and a great deal of income tax inefficiency will occur over the years. The simple addition of PPLI inside the partnership can dramatically result in substantial long term savings to the family members.

International Planning. For cross border planning, the use of internationally issued PPLI contracts can have a substantial benefit. PPLI has been used in pre-immigration and cross border employee benefit planning for years. Although the rules on life insurance differ from one country to another, the core tax aspects are still favorable in most jurisdictions. Since the basic tax treatment of policies is fairly consistent, many times the life insurance tax rules may be the only common thread for planning in the world of complicated tax treaties, as well as civil versus common law discrepancies.

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A detailed discussion of the international planning opportunities are beyond the scope of this paper. However, suffice it to say that for the international practitioner more options are being developed each day. Many view the international market as providing a much greater business opportunity for the insurance companies and advisors simply due to the more favorable laws as well as the increased acceptance of insurance products in foreign jurisdictions.

Split-Dollar Planning. Split-dollar planning remains a viable planning option, not only for employer-employee relationships, but also for estate planning purposes. We will not attempt to dissect the new regulatory scheme with the sort of detail and attention that is best left to the many excellent commentators in this arena.[35] It should suffice to say at this point that PPLI can be used with split-dollar in many different ways.

Due to the inherent flexibility of contract terms, valuation, and pricing, PPLI is uniquely suited to make split-dollar planning a unique planning tool. Proposed Regulations were recently issued that addressed many of the uncertainties of split-dollar planning. Unfortunately, the vagueness of parts of the regulations have caused additional uncertainty in this area.

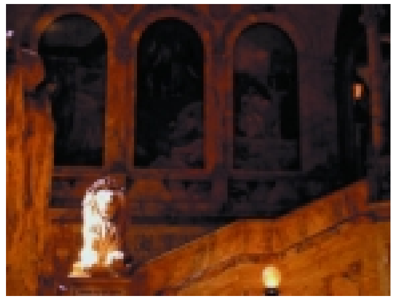
One of the areas where PPLI can be especially useful is in the valuation of the contract via special contract terms. Unfortunately, the Proposed Regulations do not include guidance regarding the precise method for valuing economic benefits received under certain split-dollar arrangements. However, the Service moved quickly to prevent the use of techniques that it felt were designed to "understate" the value of current life insurance protection and other policy benefits. In what some commentators feel was a response to a popular newspaper article,[36] the Service released Notice 2002-59 on August 16, 2002 to address the technique often classified as "reverse" split-dollar.[37]

While the reach of this Notice is not limited to "reverse" arrangements, the Service essentially prohibits the use of the Table 2001 rates or an insurer's premium rates for valuing one party's current life insurance protection when such a valuation is taken in order to establish the value of policy benefits to which another party is entitled. Although the somewhat unclear wording of Notice 2002-59 may cause additional confusion among the split-dollar planning community, it is clear that the Service is serious about curtailing the use of techniques designed to understate policy values for tax planning purposes.

Does this mean that split-dollar planning is dead? Certainly not. It simply means that practitioners will have to customize their approach even more than ever. Unfortunately, much of this customizing cannot be accomplished with traditional retail products. In the future, it is likely that the largest split-dollar plans will utilize PPLI formats rather than the current retail products.

Employee Benefit Planning. In addition to the use of split-dollar arrangements there is an increasing use of deferred compensation programs and Supplemental Executive Retirement Plans (SERPS) that need to utilize specifically designed insurance products. Although Corporate Owned Life Insurance (COLI) products will continue to be used for the masses, some recent abuses of these transactions has placed a great deal of COLI business in question.[38]

Tax Neutral Holding Vehicles. PPLI can be utilized for all types of planning where a tax neutral holding vehicle is needed. Corporations with excess cash can "park" these assets into policies on their executives to avoid the taxation of the earnings in the account. Unique planning opportunities exist for partnerships which must redeem partners who have a low outside basis in their interest. Under partnership laws, distribution of a policy created within the partnership and then distributed to the partner will obtain this carryover basis. However, since active trading of the investments can exist without relation to the basis of the policy itself, many planning opportunities exist.[39]



The nature of PPLI planning often touches nearly every aspect of securities and life insurance product regulation.

Combined With Other Techniques and Investment Products. PPLI is rarely a stand-alone technique. As it is with most techniques, PPLI is good at some things but not at others. For example, PPLI does not have the ability to customize the benefits as much as the partnership rules might allow one to customize an agreement in countless ways. However, partners still are plagued with the income tax consequences of the partnership. PPLI can be used to "turn-off" the income tax "pass-through" to the partners. This can further benefit any estate planning elements by simply increasing the size of the estate due to income tax savings.

The Regulatory Environment Of Private Placement Life Insurance

When discussing PPLI planning, it is important to briefly review the federal and state regulatory authorities that supervise such products. The nature of PPLI planning often touches nearly every aspect of securities and life insurance product regulation. While this section will highlight some of the important regulatory considerations of PPLI planning, we would encourage a comprehensive review of regulatory resources for practitioners confronting such issues.[40]

The Securities Act of 1933 and Regulation D. Most PPLI contracts are filed as a "Reg D" offering. While a discussion of each of the rules under Regulation D is beyond the scope of this article, certainly there are some highlights of which practitioners should be acutely aware. Rules 501 and 502 of Regulation D define the applicable terms and general conditions that must be satisfied to ensure the exemption, while rule 506 provides the actual 'safe harbor' to ensure private offering status. Of particular importance to the PPLI planner is the definition of *accredited investor* provided in Rule 501(a) and the *limitation on manner of offering* provisions contained in Rule 502(c). These two sections essentially dictate that PPLI may only be privately offered to individuals or entities of sufficient net worth.[41] No general solicitation or advertising by issuers or those acting on their behalf is permitted. Specifically, the rules prohibit advertisements or articles published in the general media such as newspapers or magazines, and also seminars where there has been an invitation by general advertising. Steps should be taken to ensure that all parties in a PPLI planning system are working in concert to guarantee that the appropriate Regulation D requirements are met and documented. Finally, it is important to remember that despite the registration exemption, the anti-fraud provisions of the securities laws still apply to these products, and certain state laws may impose additional requirements on private offerings.

State Insurance Regulation. While most PPLI products are exempt from federal securities registration, the regulation of the business of insurance has traditionally been left to the states.[42] As a result, securities registration exemption will not exempt a PPLI product or any accompanying distribution channels from state registration and regulation.

State insurance regulation can affect much of the PPLI planning and implementation process. Most states require licensure for agents soliciting, selling, or collecting premiums for insurance in that state, so planners seeking insurance-based fees need to seek proper licensure. In addition, insurance carriers must seek approval of their proposed contracts from the proper regulatory authorities. Indeed, everything from a determination of applicable insurance premium taxes and retaliatory tax provisions to what constitutes "solicitation" in a particular state might need to be considered depending on the individual case.[43]

Solicitation Issues and Offshore Products. Offers and sales of securities made outside the U.S. might qualify for an exemption from 1933 Act registration requirements under the rules of Regulation S. Similar to Regulation D in some respects, Regulation S operates as a safe harbor from registration for offers and sales that occur outside of the U.S. Under Rule 903, offers or sales of securities are considered to occur outside of the U.S. if they are made in an *offshore* transaction and there are no *directed selling efforts* made in the U.S. In general, *directed selling efforts* include any activity undertaken to condition the U.S. market for the sale of a security, such as advertisements in general circulation publications, while *offshore transactions* are those involving an offer and order for a security that occurs outside the U.S.[44] The antifraud provisions of the securities laws, as well as additional requirements imposed by the 1934 Act, still apply to these offerings. State insurance law should again be examined to ensure that issues relating to the reach of a particular states' regulatory scheme have been addressed. It is the unwise practitioner who assumes that offshore PPLI planning can operate in a "bubble" completely free from regulation.[45]

The Future Of PPLI

As the PPLI market develops, the most obvious growth potential for sophisticated life insurance products is not in the U.S. market at all, but rather in the foreign markets. Since the tax laws of most other jurisdictions are generally much more favorable to life insurance, common sense dictates that its use may be much more important abroad. Although the practical uses of foreign qualifying contracts will have limited use for the domestic tax planner, those with a cross-border practice will find these new versions highly attractive for solving difficult multi-jurisdictional transfer problems.

For most U.S. practitioners, the largest area of growth will be coming out of the institutional setting. As private bankers and large investment management groups become more integrated with PPLI, practitioners will face many more questions from their clients regarding this technique. In the past, many practitioners have simply dismissed the idea when their client was presented it via some questionable offshore investment promoter. That same practitioner will be unable to easily dismiss it when it comes from a client who was presented the idea by a major trust, bank or investment firm who may very well already send more traditional business to the practitioner.

As the market develops, carriers and products will go through several market adjustments. First, certain carriers will simply get out of the business because they never made a concerted effort to meet the right market demands. Other carriers will be so unyielding in their approach, administration, or facilitation that they will loose all credibility in the market. Others will simply adjust to market pressures to fulfill the needs of the planning community. Certain carriers will build unyielding products and try the mass marketing approach.

The successful carriers will understand that the market is really the planning community and will build products that are conducive to a planner's perspective rather than to a product salesperson. The most difficult issue is the ability of carriers to provide adequate sales support to traditional non-insurance based professionals. Unfortunately, most carriers have simply provided a "product" platform, while most practitioners have a "planning" platform, and there is quite a bit lost in the translation. Today, most successful programs are being implemented when tax planners are brought in to train the investment and tax professionals in more of a mentoring fashion.

Integrating PPLI Into Ones Practice Or Institution

Perhaps the biggest hurdle for clients to actually utilize the benefits of PPLI is the substantial information gap that exists in the planning community regarding PPLI. Since the revitalized interest in PPLI is relatively new, many practitioners are either totally unaware of PPLI, or have only a brief recollection of reading an article or attending a professional seminar where some individual briefly discussed PPLI.

More importantly, since PPLI first came back via the international versions, several less than reputable foreign carriers were started that had neither the credentials nor the financial backing to make any prudent practitioner comfortable. This has led to many practitioners simply lumping the good with the bad, and they have thus discounted PPLI as "one of those international tax scams". As it is inevitable that certain companies (mostly international) and some advisors will abuse the tax and regulatory laws, the fact remains that the vast majority of PPLI carriers and practitioners are good quality players.

Summary

Perhaps the most important message of this paper has been to illustrate the inherent planning attributes of Private Placement Life Insurance in a multitude of settings. PPLI *IS* a planning tool *NOT* a product to be sold. It is only through the diligent application of specific facts, and the integration of investment, tax, and insurance attributes that PPLI will make sense in any client's overall plan.

As the market develops, and more investment options are added to the fold, retail type versions will appear (and to a certain degree they already have) that are labeled as PPLI but really offer none of the true benefits of PPLI. It is up to the practitioner to sift through the sales pitches and verify the credibility and applicability of a certain program. PPLI is not for everyone, just like any other planning tool, and there will be cases involving premiums under $1 million when the client will best be served by a traditional retail contract. No insurance company, institution, or insurance distribution source has all the answers. Therefore, it is up to the planning practitioner to lead the process, and implement only those programs that are best suited for the client's long term objectives.

As the market develops new variations will surface, and of course it is inevitable that the Internal Revenue Service will be faced with new Rulings requests and fact patterns that will force them to refine their own positions on PPLI. Assuming that the core benefits of PPLI remain, it will clearly be a viable planning tool for the years to come.

Endnotes

[1] See generally Rev. Rul. 77-85, 1977-1 C.B. 12, Rev. Rul. 80-274, 1980-2 C.B. 27, Rev. Rul. 81-225, 1981-2 C.B. 12, Rev. Rul. 82-54, 1982-1 C.B. 11, and Rev. Rul. 82-55, 1982-1 C.B. 12.

[2] Each of the fifty states charges a premium tax on life insurance and annuity premiums. It is effectively a sales tax and is measured against the gross amount of premium paid. The carrier is then required to collect this tax and pay it to the appropriate state.

[3] For a general overview of conducting due diligence on foreign carriers, see Grant R. Markuson, *The Secrets of International Private Placement Variable Insurance Contracts*, J. Practical Estate Planning, August-September 1999.

[4] For a detailed discussion of the testing under I.R.C. § 7702, see Howard M. Zaritsky & Stephan R. Leimberg, *Tax Planning with Life Insurance: Analysis with Forms* (Warren, Gorham & Lamont 2nd ed. 1998).

[5] I.R.C. § 7702(b).

[6] I.R.C. § 7702(c).

[7] I.R.C. § 7702(d). A contract falls within the cash value corridor of this subsection if the death benefit under the contract at any time is not less than the applicable percentage of the cash surrender value. See Chart 1.

[8] The term "face amount" is the actual death benefit of a policy. The "cash value" is the actual underlying value of the investments within the policy.

[9] A more detailed definition can be found at I.R.C. § 817(d) and in *Tax Planning with Life Insurance: Analysis with Forms*, supra note 4.

[10] See I.R.C. § 101(a)(1).

[11] See I.R.C. § 101(a)(2) and Treas. Reg. § 1.101-1.

[12] See I.R.C. § 101(c) and § 101(d).

[13] See I.R.C. § 2042.

[14] See I.R.C. § 2035.

[15] See generally I.R.C. § 7702(g) regarding taxability if the contract fails to qualify as life insurance under applicable law.

[16] See I.R.C. § 7702A and I.R.C. § 72(e)(10).

[17] See generally I.R.C. § 72(b)(3).

[18] See I.R.C. § 7702A(b) "...a contract fails to meet the 7-pay test of this subsection if the accumulated amount paid under the contract at any time during the 1st 7 contract years exceeds the sum of the net level premiums which would have been paid on or before such time if the contract provided for paid-up future benefits after the payment of 7 level annual premiums." It is important to note that the 7-Pay test is based upon the mortality costs of the 1980 CSO tables. Since the true costs of the policy are often much less, it is not unusual to see a Non-MEC with a term of four or five years, rather than the safe harbor of seven. For a discussion of the flexibility of the 7-pay test, see generally, *Tax Planning with Life Insurance: Analysis with Forms*, supra note 4 at 4-32-33.

[19] See I.R.C. § 72(v).

[20] See I.R.C. § 7702A(c)(2) regarding the treatment of a reduction in benefits during the 1st 7 years.

[21] See H.R. Conf. Rep. 98-861, 98th Cong., 2d Sess. at 1054-55 (1984), *reprinted in* 1984 U.S.C.C.A.N. 1445, 1742-43.

[22] See I.R.C. § 817(h)(4).

[23] Treas. Reg. § 1.817-5(c)(2)(i).

[24] Treas. Reg. § 1.817-5(c)(2)(ii). The regulations provide specific definitions and limitations for real property accounts that must be reviewed when such holdings are contemplated.

[25] See I.R.C. § 817(h).

[26] See Treas. Reg. § 1.817-5.

[27] For a detailed review of the rulings and regulations surrounding investor control in variable annuity and life insurance products see Wayne K. Johnson, *An Overview of the "Investor Control" Issue*, Conference on Life Insurance Company Products: Current Securities, Tax, ERISA, and State Regulatory Issues, ALI-ABA (November 12, 1993).

[28] Rev. Rul. 82-54 1982-1 C.B. 11.

[29] Priv. Ltr. Rul. 200244001 (May 2, 2002). Although issued in May, due to the request of reconsideration by the initial company requesting the ruling, it was not released until November 1, 2002.

[30] Priv. Ltr. Rul. 9851044 (Sept. 22, 1998). See also Priv. Ltr. Rul. 9433030 (May 25, 1995).

[31] See S.D. CODIFIED LAWS ANN. § 10-44-2. An example of premium tax changes and additional changes useful for PPLI planning implemented in South Dakota in 2001 can be found in a review of Senate Bill No. 225, *available at* http://legis.state.sd.us/sessions/2001/bills/SB225enr. htm.

[32] See I.R.C. § 953(d). Under this Code Section, certain foreign insurance companies might elect to be treated as domestic corporations.

[33] See I.R.C. § 4371.

[34] I.R.C. § 848.

[35] See generally, Lawrence Brody, Michael D. Weinberg, and Mary Ann Mancini, *Using Split-Dollar Insurance in Estate Planning Under the Proposed Regulations*, A.B.A.-C.L.E. & SEC. REAL PROP. PROB. & TR. L. (July 30, 2002). To review some detailed commentary submitted on the proposed regulations, see *ACLI Comments on Proposed Regs on Split-Dollar Life Insurance Arrangements*, Public Comments on Regulations, Oct. 7 2002, *available in* TAXBASE, 2002 TNT 197-15. For a brief historical survey on the many recent developments in split-dollar insurance planning, see Burgess J.W. Raby & William L.Raby, *The Split-Dollar Life Insurance Regimes, The Insurance Tax Review*, March 2002, p.499.

[36] See David Cay Johnston, *Death Still Certain, but Taxes May Be Subject to a Loophole*, N.Y. Times, July 28, 2002, Section 1, Page 1.

[37] See Notice 2002-59; 2002-36 IRB 1 (16 Aug 2002).

[38] For a discussion of the court battles in the COLI arena, see David Lupi-Sher, *Three Strikes, You're Out – The COLI Wars, The Insurance Tax Review*, April 2001, p.589.

[39] For a review of the rules for transfers of interests in a partnership, see generally I.R.C. §§ 741 – 743.

[40] For a general discussion on the regulatory issues confronted in private placement life insurance planning, see Steven B. Boehm and Thomas E. Bisset, *Privately Placed VLI Products: Charting The Regulatory Waters*, Conference on Life Insurance Company Products Current Securities, Tax, ERISA, and State Regulatory Issues, SF36 ALI-ABA 551 (2000).

[41] See Rule 501 of Regulation D of the Securities Act of 1933 where individual "accredited investors" must have a net worth exceeding $1,000,000 or annual income in excess of $200,000 (individually) or $300,000 (jointly).

[42] Unless Congress chooses to introduce specific federal legislation relating to the business of insurance, the power to regulate insurance has been granted to the states. See the McCarran-Ferguson Act codified at 15 U.S.C. §§1011-1015.

[43] For example, the Florida Insurance Code defines transacting insurance in that state as: solicitation or inducement, preliminary negotiations, effectuation of a contract of insurance, or transaction of matters subsequent to effectuation of a contract of insurance and arising out of it. See FLA. STAT. ch. 624.10. In South Dakota, insurance business is defined as the transaction of all matters pertaining to a contract of insurance, both before and after the effectuation of that contract, and all matters arising out of that contract of any claim thereunder. See S.D. CODIFIED LAWS ANN. § 58-1-2.

[44] See Rule 902 of Regulation S of the Securities Act of 1933.

[45] Many states have adopted legislation similar to the Unauthorized Insurers Process Act developed by the National Association of Insurance Commissioners. This act provides a list of the activities of insurance companies that a state might use in an attempt to reach a foreign insurer within its regulatory scheme.

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